

## **Budgetary Reforms for Growth and Poverty Reduction in Pakistan**

SADIQ AHMED

### **I. WHAT IS AN INSTITUTION?**

Webster's Dictionary defines institution as "an established order, principle, law or usage as an element of organised society or of civilisation". There are other interpretations of this term, depending upon the context for which the term is needed. For the purposes of the theme of this 19th Annual General Meeting of the Pakistan Society of Development Economists (PSDE), "Institutional Change, Growth and Poverty", I find this well-crafted Webster Dictionary definition to be appropriate and adequate.

There is now strong recognition that institutional reforms are necessary to sustain rapid growth and poverty reduction in developing countries. However, it is first necessary to identify and specify what these institutional reforms are. A number of systematic efforts to define institutions in an analytical context have been undertaken. For example, the World Development Report (WDR) 2002 of the World Bank focused on "Building Institutions for Markets" as the core theme of the report.<sup>1</sup> There has been emphasis on aspects of institutions in other WDRs as well, including in the WDR 1997 on the Role of the State,<sup>2</sup> the WDR 2003 on Environment,<sup>3</sup> and the most recent WDR 2004 on Service Delivery.<sup>4</sup> Each of the WDRs builds on the analysis of earlier WDRs and provides analysis of the institutional context of the development challenge in concrete terms to make associated reforms implementable. This is indeed a laudable effort and provides a fairly rich analytical base over which one can build on to move the institutional reform agenda forward.

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<sup>1</sup>World Bank (2001).

<sup>2</sup>World Bank (1997).

<sup>3</sup>World Bank (2002).

<sup>4</sup>World Bank (2003a).

For the purposes of this paper, I will focus on one core institution, using the broad definition provided by the Webster Dictionary as noted above. I identify this institution as the Government Budget and the theme of the paper is how Budgetary reforms can support growth and poverty reduction in Pakistan.

It is fair to ask in what sense is the Budget an Institution? It is easy to see that the government Budget is probably the most powerful established order, principle or law that affects the functioning of the modern society. Budget provides the government legal authority to tax earnings of a private citizen. Budgetary principles and laws influence the functioning of the markets in ways that no other single institution can possibly do in today's modern economy. Formulation of the Budget reflects the multitude of political interests and coalition that underlie the political governance of a society. Having a voice in Budget formulation and implementation is perhaps the most effective way of giving voice to the civil society to affect its well-being.

The influence of the Budget on growth and poverty reduction is well recognised. This can happen through a variety of ways. For example, budgetary decisions through taxation, borrowing and spending affect incentives for business and household decisions in such key areas as savings, investments, exports and imports that have implications for employment and growth. Budgetary spending can also affect poverty through the direct provision or funding of core services and targeted poverty reduction programmes. There is a rich body of empirical research that one can draw upon to illustrate the role of the Budget in affecting growth and poverty reduction. We will return to this subject later in the paper.

Against the backdrop of this introduction, the remainder of the paper is organised as follows. In Section II, I develop a brief analytical framework that shows the different institutional dimensions of the Budget and how they need to be reformed to ensure that the Budget is indeed supportive of higher economic growth and poverty reduction. In Section III, I apply this framework to the specific context of Pakistan. Finally in Section IV, I provide some concluding remarks.

## **II. CORE INSTITUTIONAL DIMENSIONS OF THE BUDGET: AN ANALYTICAL FRAMEWORK**

The Budget inherently is a political instrument and is used as such. Therefore, formulating and implementing a budget is essentially the outcome of the interplay of coalition of a number of political and social interest groups. *"The budget is the critical link on the long route of accountability connecting citizens to providers through politicians and policy-makers"*, notes the WDR 2004 (p. 181). Consequently, securing a good budget, which I define as *a budget that minimises the disincentive effect of taxation and borrowing while ensuring that resources thus mobilised are spent for promoting growth and reducing poverty*, will require that the underlying political decisions are consistent with the outcome of a good budget. This in turn

requires attention to a number of core institutional aspects that are critical for ensuring that the budget indeed contributes to the desired outcomes.

For analytical purposes, these core institutional dimensions can be described as follows:

- budget deficit and debt management;
- taxation management;
- managing public spending;
- allocating responsibility by levels of government;
- predictability and transparency of the budget;
- expenditure tracking and monitoring;
- public accounts.

How are these institutional components related to each other and how do they work to lead to good or bad budget outcomes?

**Budget Deficit and Debt Management.** Budget deficit and public debt are obviously inter-related. The deficit outturn and associated financing decisions can have major effects on growth and poverty reduction. For example, the budget deficits were insignificantly small or in surplus in the 1990s among the best-performing countries but averaged over 10 percent of GDP among the worst-performing countries [WDR (2002)]. Sustained large budget deficits can easily lead to debt explosion and economic decline, causing tremendous political, economic and social difficulties. The world today is replete with such examples, including the well-known HIPC (highly indebted poor countries) phenomenon.

Despite well-known adverse consequences of prolonged large fiscal deficits, many countries are only too willing to let this happen. Why? And what can be done to address this problem? The level of deficit is a political decision and politicians are often happy to leave the problem alone if they can get away with it (i.e., they do not face a crisis situation) because correcting these deficits are politically painful (higher taxation and or spending cutbacks are both unpalatable to politicians because they tend to create adverse political reactions in the short run while benefits normally occur in the longer term). So, while the obvious solution to lower deficit is to raise revenues and restrain spending, these reforms are not easy to obtain. However, a number of institutional arrangements related to Budget management can help. These include: a strong finance ministry with authority to resist budgetary amendments; fiscal responsibility bills; and restriction on borrowing at lower levels of government. Evidence suggests that all these rules and regulations if used well can have a positive impact in limiting budget deficits [WDR (2002)].

**Taxation Management.** The budget deficit and public debt in turn are the results of two other related institutional aspects of the budget: taxation and spending decisions. Taxation is inherently unpopular and has been so in all societies and in all times. Public spending on the other hand is welcomed by beneficiaries. The

management of taxation brings out tremendous political challenges of vested interest of all types, especially in developing countries where tax administration is very weak. Elite capture and corruption in many developing countries have often lead to low tax collection as well as reliance on inefficient taxes that distort resource allocation. The outcome often is negative impact on growth and equity. For example, except in Sri Lanka, on average annual total tax collection in the South Asia Region (SAR) is not only quite low, ranging between 9 percent of GDP to 13 percent of GDP, income tax compliance is only between 6-16 percent [Ahmed (2002)].<sup>5</sup> Such low income tax compliance is reflective of the political power of the elites and vested interests. Addressing this requires among other things bringing the relevant information out to the general public in order to have an important debate how to solve the following problem of the collective: raising sufficient revenue in an equitable and efficient way to pay for public good provision. Demonstrating compliance with tax laws by the politicians and elites will be helpful. Also, the government's ability to offer quality public services to citizen's is a critical determinant of tax compliance.

On the institutional front, the low income tax compliance is a reflection of poor tax administration. International evidence suggests that establishing an autonomous tax agency can help improve tax administration [WDR (2002)]. However, simply declaring a tax administration as autonomous on paper will not work. Along with strong political commitment that backs up the working of this agency by withdrawing protection of the offenders and letting the penalty system work, partnership with the business community to support an efficient and equitable tax agency will be necessary.

**Managing Public Spending.** Spending decisions are equally political in nature. Elite and vested interest capture are common phenomenon. Spending capture can reflect interests of powerful specific institutions such as the military (defense spending), the civil service (levels of employment and wage and pensions bills), public enterprises (levels of subsidy), and farmers (subsidy on power, water, food procurement). Equally worrisome, public spending is often constrained by fixed commitments due to poor fiscal management of past governments (e.g. interest payments on public debt). Consequently, it is often the case that public spending for supporting growth (e.g. infrastructure) and human development (health, education, water supply) are a relatively a small share of total spending. For example, in SAR countries, on average a dollar of public spending is distributed as follows: 20 cents goes to interest payments, 11 cents to defense, 16 cents to upkeep of civil servants and 13 cents for largely untargeted subsidy payments. Only the remaining 40 cents goes for basic infrastructure and human development [Ahmed (2002)]. Recognising the importance of managing public spending for service delivery for the poor, the

<sup>5</sup>Even for Sri Lanka, the average tax collection per annum (17 percent of GDP) is low relative to spending (25 percent of GDP).

WDR 2004 notes as follows: *“When services fail poor people, a good place to start looking for the underlying problem is almost always how the government spends money. If politicians and policy-makers spend more than they can sustain, services deteriorate. If budgets are misallocated, basic services remain underfunded and frontline providers are handicapped. And if funds are misappropriated, service quality quantity and access suffer”* (p. 181). So, securing an efficient and equitable tax system as well as ensuring that public spending is channeled to areas that support growth and poverty reduction are major institutional challenges in most developing economies.

**Allocating Responsibility by Levels of Government.** The effectiveness of public spending in terms of contribution to growth and poverty reduction outcomes is in many instances limited by poor service delivery. It is not just the level of funding but how the money is used to provide service which matter. Service delivery weakness of the public sector often result from its highly centralised structure, leading to disconnect between providers and beneficiaries and poor accountability. So, a proper allocation of responsibility for budget formulation, financing and implementation by appropriate levels of government is a key institutional challenge for good Budget management. However, as the WDR 2004 notes, decentralisation by itself cannot be a panacea for resolving public sector service delivery problems. Successful decentralisation should be based on the key principles of accountability, transparency (to the public) and clear lines of responsibility in revenue and expenditure assignment. So, making decentralisation deliver the intended outcomes requires a careful design of the intergovernmental fiscal relations, getting the administrative structure of local governments in place, developing local government capacities, establishing clear accountability mechanisms and ensuring transparency at all levels.

**Predictability and Transparency of the Budget.** Budget decisions are typically carried out on an annual cycle (known as fiscal year) whereas outcomes require longer-term commitments. Fluctuations in revenues and uncertainties about availability of foreign aid on an annual cycle along with lumpiness of many public capital spending means considerable uncertainty in matching resource needs to revenues on a yearly basis. Yearly budgetary fluctuations can cause major difficulties in meeting financial commitments or completing projects efficiently and on time. Often, the budget is based on incomplete or inadequate information, especially at the sectoral expenditure level, either because of poor planning or because line ministries hide true costs to get project approvals. These in turn can have serious adverse effects on efficient use of public resources. One possible option to improve the transparency and predictability of the budget is the use of medium-term budgetary framework (MTBF). These are now becoming increasingly popular in developing countries. A well-designed MTBF can be a powerful instrument for improved budgetary management, provided adequate capacity is in place including efforts to improve the information base.

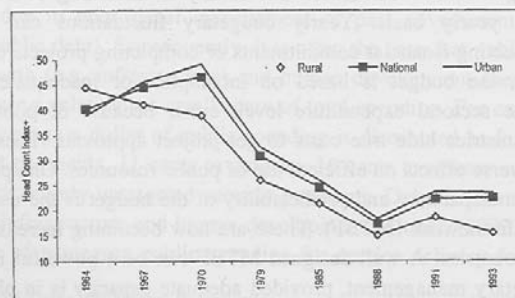
**Expenditure Tracking and Monitoring.** While proper allocation of budgetary responsibility by levels of government can be very helpful in establishing better accountability, it is still important to know how public resources are actually been spent at all levels of government. This information is necessary not only to make midway corrections as necessary but also to assure both public officials and citizens that money is actually being spent on the intended purpose. Also, good analysis of the impact of public spending on economic outcomes is needed. Both these information can be very powerful in giving citizens a voice when there are concerns about the effectiveness of public spending.

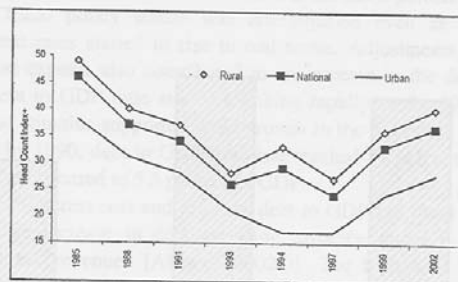
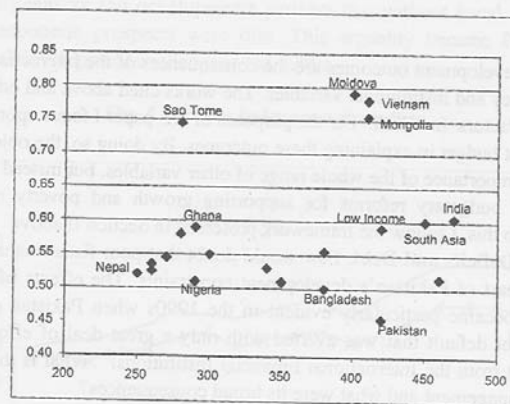
**Public Accounts.** Finally, proper audit of the budget to account for all revenues mobilised and all monies spent is a essential to ensure financial discipline and accountability, which are critical for the overall effectiveness of the Budget. Without independent audits that are made available to the public and a system of diligent follow up to the reservations expressed in the audit report, there is a serious risk that public resources will be wasted either through corruption or through inefficiency or both. Poor performing budgets are often a reflection of the lack of institutional arrangements for ensuring the formal accountability for public funds.

### III. BUDGET'S EFFECTS ON GROWTH AND POVERTY REDUCTION IN PAKISTAN: THE HISTORICAL CONTEXT

Much has been written about Pakistan's development performance, its achievements and challenges. Recent work among others includes those of Ahmed (2002a), Hussain (1999) and Hasan (1998). The evidence shows that Pakistan made good progress in reducing poverty in the 1970s and 1980s, but poverty increased in the 1990s (see Figures 1 and 2).<sup>6</sup> The achievements in terms of progress with human development is even more worrisome, lagging behind those of other countries with similar per capita incomes in most areas (Figure 3). This has led analysts to diagnose

Fig. 1. Pakistan's Progress in Poverty Reduction 1964–1993.

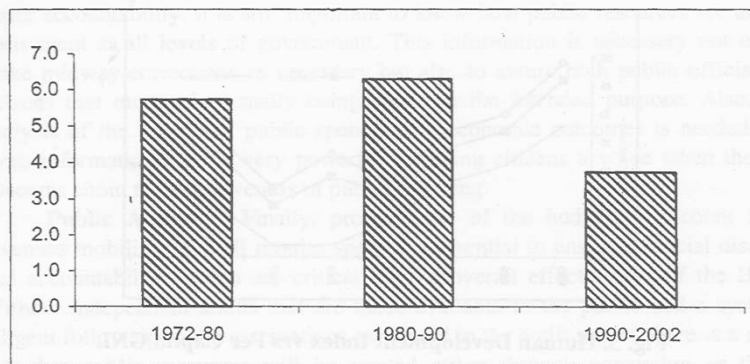


**Fig. 2. Pakistan's Progress in Poverty Reduction 1985–2002.****Fig. 3. Human Development Index vs Per Capita GNI.**

Pakistan as suffering from a serious “Social Gap”, defined as the difference between the actual social indicators and predicted social indicators if Pakistan had performed similarly as the average for comparable per capita income countries. The growth outcomes have depicted a pattern similar to poverty trends: rapid growth in the 1970s and 1980s, then declining significantly in the 1990s (Figure 4). As well, growth in the 1990s was more volatile than in the earlier two decades due to external shocks including the effects of drought. The adverse effects of the drought have been particularly severe for the rural poor.

<sup>1</sup>This term was coined by Easterly (2001) and the analysis of the social gap is contained in that paper. See also World Bank (2002a) and World Bank (2002b).

Fig. 4. Trends in GDP Growth.



These development outcomes are the consequences of the interaction of a large number of policy and institutional variables. The works cited above and other research analyse these factors in detail. For the purposes of this paper I focus upon the role of the government budget in explaining these outcomes. By doing so, the objective is not to belittle the importance of the whole range of other variables, but instead to show the importance of budgetary reforms for supporting growth and poverty reduction in Pakistan. To do this, I follow the framework presented in Section II above.

**Fiscal Deficits and Debt.** Few would doubt that poor fiscal management has been at the heart of Pakistan's development constraints. The effects of poor fiscal management became particularly evident in the 1990s when Pakistan came to the verge of a debt default that was averted with only a great deal of effort and from strong support from the International Financial Institutions.<sup>7</sup> What is the genesis of poor fiscal management and what were its broad consequences?

Pakistan's fiscal crisis of the 1990s had its roots in poor fiscal management in the 1970s and 1980s. On average, Pakistan ran fiscal deficit of about 7.5 percent per annum between 1972 and 1992. Initially, a rapid pace of growth, fueled in part by the fiscal stimulus, and negative real foreign interest rates, allowed debt to GDP ratio to fall and the interest cost of deficits to stay low [Ahmed (1994)]. Thus, debt to

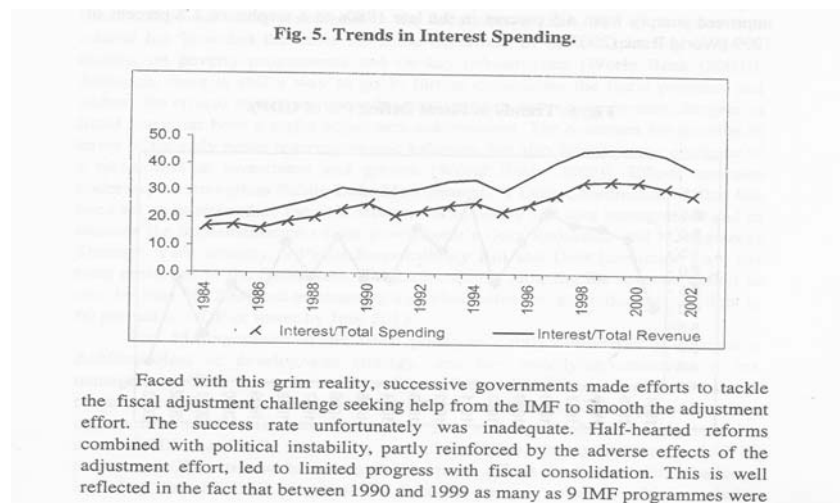
<sup>7</sup>By December 1998, as a result of the combined effects of G-7 sanctions and drying up of private capital flows, Pakistan's reserves plunged to below \$200 million, leading to the prospects of a debt default to its preferred creditors. This was avoided through a massive effort by the then economic team to implement a strong reform programme with support from the World Bank, ADB, and IMF, leading to bop assistance of close to a billion dollars that helped Pakistan shore up its fragile reserves position while meeting its obligations to preferred creditors.



GDP ratio actually fell from 79 percent in 1973 to 50 percent in 1981. The interest cost of large fiscal deficits was also contained at around 2 percent of GDP. But this expansionary fiscal policy stance was not adjusted even as international and domestic interest rates started to rise in real terms. Adjustments in exchange rate needed to boost exports also contributed to an increase in the debt to GDP ratio. Overall, the debt to GDP ratio started climbing rapidly in the 1980s, even though continued fiscal stimulus supported rapid growth in the 6 percent per annum range. Consequently, by 1990, debt to GDP ratio had reached 84 percent. Importantly, the interest cost of debt soared to 5.5 percent of GDP.

The rising interest cost and growing debt to GDP ratio was not accompanied by commensurate increase in debt servicing capacity, either in terms of export earnings or in tax revenues [Ahmed (2002a)]. The budgetary problem became particularly acute as the share of interest cost in total spending and total revenues rose rapidly during the 1990s, leaving an increasingly lower share of resources for financing Pakistan's development needs (see Figure 5). It became increasingly clear to the policy-makers and developments partners that without fiscal adjustment, the country's economic prospects were dim. This arguably became Pakistan's most fundamental development challenge in the 1990s.

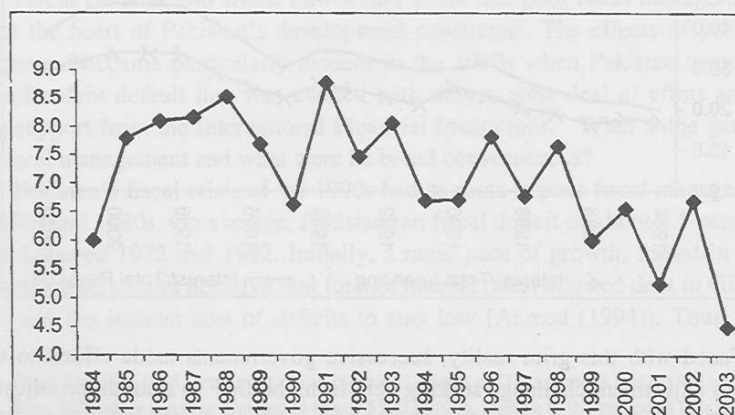
**Fig. 5. Trends in Interest Spending.**



negotiated and abandoned with no programme being completed. These negotiations involved as many as 6 governments and 8 Finance Ministers.

What was the underlying constraint? Quite apart from difficulties due to poor governance, the basic problem was that the required magnitude of adjustment was quite difficult for any political government to handle. Fiscal stimulus in the 1970s and 1980s supported a rapid pace of growth that was no longer sustainable in the 1990s. Reducing fiscal deficits from the 9-10 percent level to the 3-4 percent sustainable level entailed a massive amount of belt tightening (5-6 percent of GDP). At the same time, rising real interest rates made the challenge even more difficult. Thus, for example, development spending in real terms fell by 40 percent over 1991-2001 and its share in total spending fell from 25 percent to only 13 percent [World Bank (2003)]. So, the combined effects of the fiscal crunch and rising interest rates dampened reduced investor confidence and adversely affected economic growth, creating income and employment problems. These difficulties were aggravated by rising oil prices and slow down in the expansion of remittance inflows. The result was political resistance to adjustment efforts, contributing to a stop-go pattern of fiscal adjustment (Figure 6). Even so, by 1999, the fiscal deficit had come down to 5.6 percent of GDP, falling from 9 percent in 1991. Importantly, the primary balance improved sharply from 4.5 percent in the late 1980s to a surplus of 1.2 percent in 1999 [World Bank (2003)].

**Fig. 6. Trends in Fiscal Deficit (% of GDP).**



Given this depth of the fiscal adjustment and the associated cuts in public investment, it is hardly surprising that the growth rate plummeted from over 6 percent per annum in the 1980s to around 4 percent in the 1990s. Clearly, this substantial fiscal adjustment was achieved at the cost of growth. While part of the adjustment cost was probably unavoidable due to the massive scale of the adjustment effort, a better adjustment programme that put more emphasis on resource mobilisation, protecting core non-interest, non-defense public spending, and finding other ways to reduce the interest cost of the deficits (such as reducing high-cost government sponsored saving schemes) would have helped avoid the severity of the adjustment cost. Indeed, that was the advice given by the IFIs. It was not implemented due to political factors [Ahmed (2002)].

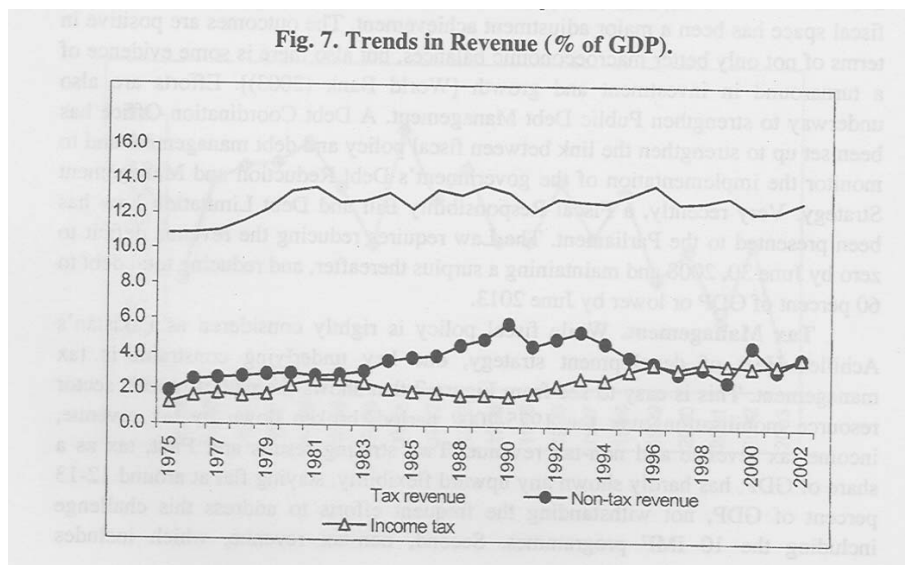
Circumstances changed quite positively during 2000-2003. First, a reform minded military government came to power in October 1999. The government has the credit of sticking to a full 3-year IMF programme. Second, there was a very favourable round of Paris Club debt rescheduling negotiations. Third, there has been a substantial increase in remittance inflows. And fourth, interest rates came down quite sharply, both internationally and domestically, while the exchange rate stabilised. The combined effects of these factors was a further consolidation in the fiscal deficit and a sharp decrease in the fiscal cost of debt. The fiscal space thus created has provided the basis for some expansion of critical spending in social sectors, on poverty programmes and on key infrastructure [World Bank (2003)]. Although, there is still a way to go to further consolidate the fiscal progress and address the critical development needs to spur growth and reduce poverty, the gain in fiscal space has been a major adjustment achievement. The outcomes are positive in terms of not only better macroeconomic balances, but also there is some evidence of a turnaround in investment and growth [World Bank (2003)]. Efforts are also underway to strengthen Public Debt Management. A Debt Coordination Office has been set up to strengthen the link between fiscal policy and debt management and to monitor the implementation of the government's Debt Reduction and Management Strategy. Very recently, a Fiscal Responsibility Bill and Debt Limitation Law has been presented to the Parliament. The Law requires reducing the revenue deficit to zero by June 30, 2008 and maintaining a surplus thereafter, and reducing total debt to 60 percent of GDP or lower by June 2013.

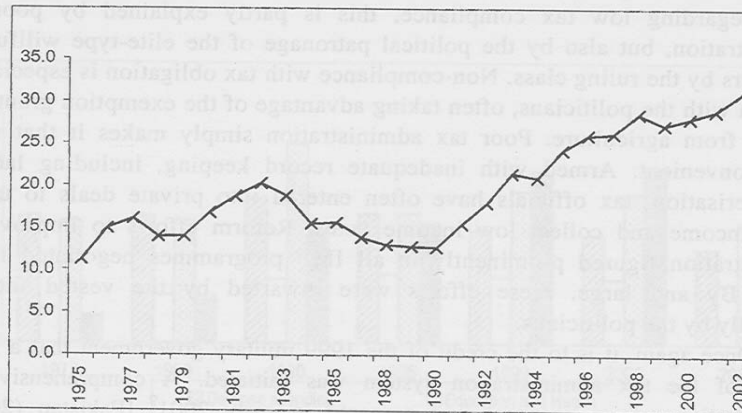
**Tax Management.** While fiscal policy is rightly considered as Pakistan's Achilles Heel of development strategy, one key underlying constraint is tax management. This is easy to see from Figure 7 that shows the path of public sector resource mobilisation over the 1975-2002 period, broken down by tax revenue, income tax revenue and non-tax revenue. Two striking results are: First, tax as a share of GDP, has hardly shown any upward flexibility, staying flat at around 12-13 percent of GDP, notwithstanding the frequent efforts to address this challenge including the 10 IMF programmes. Second, non-tax revenue, which includes

proceeds from public services including distribution of petroleum products and profit transfers from the Central Bank operations, grew significantly between 1975–90, growing to 6 percent of GDP in 1990, but then declined to around 4 percent of GDP in the 1990s. The fluctuations in non-tax revenue in the 1990s mainly reflect the fluctuations in profit transfers from the Central Bank operations and from sale of petroleum. Third, income tax revenue has not only been very low but actually declined as a share of GDP in the 1980s. The tax debacle is the direct manifestation of a major institutional problem in Pakistan—poor tax management.

The problem of tax management has two inter-related dimensions. One is the tax structure, and the second is tax administration. Pakistan's tax structure has traditionally been characterised by the dominance of indirect taxes—international trade taxes, domestic sales taxes and excise duties. As noted above, direct taxes, such as income tax and tax on wealth, has been a low proportion of total tax revenue. As Figures 7 and 8 show, the share of income tax in total tax barely improved until the 1990s. Quite apart from the issues of equity and tax buoyancy, this inefficient tax structure has distorted incentives for investment and exports, thereby weakening the growth impact of the budget. Within the indirect tax category, however, there has been some recent progress. Importantly, the share of international trade taxes has come down sharply from 30 percent in 1995 to 16 percent in 1999 and to 11 percent in 2002. As well, very recently, efforts are underway to introduce a broad based sales tax as a step towards establishing a value-added tax. Finally, some progress has been made in increasing revenues from income taxes in the 1990s, growing from 2 percent of GDP in 1990 to 3.4 percent in 1999 and to 4.0 percent in 2002.

Fig. 7. Trends in Revenue (% of GDP).



**Fig. 8. Income Tax/Total Tax (%).**

Regarding tax administration, the worst aspects of poor political governance have dominated tax mobilisation effort. The reasons for the low income tax effort in Pakistan is first that the tax base is very low because a large segment of the economic activity base has been out of the tax loop either by law (agriculture) or because of the lack of documentation (the grey economy). A second reason is the weak administrative capacity and corruption of the tax administrative machinery. A third and related reason is the wilful non-compliance by the elite class based on political patronage.

The legal exemption of agriculture from the tax base is a reflection of the power and authority of the land-owning class in the Pakistani politics. World around, including Pakistan, feudalism is well-known to heavily influence economic and social decision making in view of its tremendous political clout. So, it is little wonder that two areas where progress has basically stalled in Pakistan concerns taxation of agricultural income and land reforms. Responding to donor pressures, weak attempts to introduce some kind of agricultural income tax happened in the 1990s. Little progress in implementation happened. In 2000 July, all provinces finally enacted the agricultural income tax. Despite this, however, the collection effort remains weak.

Regarding inadequate documentation and the gray economy, the main political consideration has been the street power of the large number of traders in Pakistan. Again, responding to donor pressure, numerous efforts were made in the 1990s to bring the trading community in the tax net through proper documentation and record keeping. However, little progress was achieved. Finally, though, in late 2000 a breakthrough was achieved by the military government in enforcing the

documentation process for the trading community. Sustaining and expanding this effort remains a major challenge.

Regarding low tax compliance, this is partly explained by poor tax administration, but also by the political patronage of the elite-type willful tax defaulters by the ruling class. Non-compliance with tax obligation is especially a problem with the politicians, often taking advantage of the exemption granted to income from agriculture. Poor tax administration simply makes it that much more convenient. Armed with inadequate record keeping, including lack of computerisation, tax officials have often entered into private deals to under-report income and collect low income taxes. Reform efforts to improve tax administration figured prominently in all IMF programmes negotiated in the 1990s. By and large, these efforts were thwarted by the vested interest, especially by the politicians.

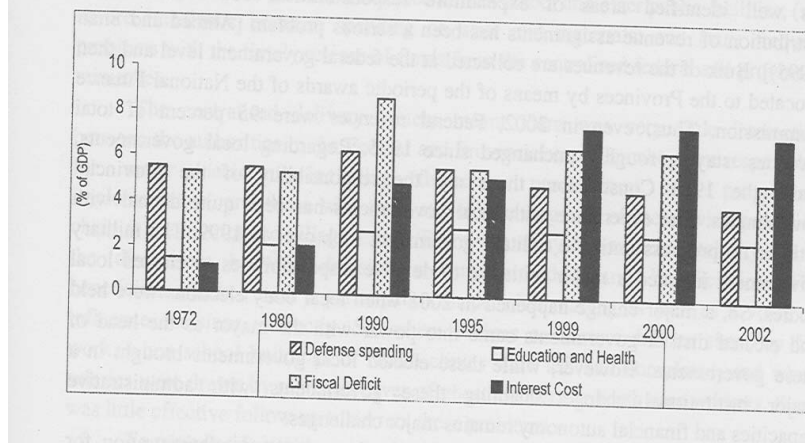
Once again, it is to the credit of the 1999 military government that a major reform of the tax administration system was initiated. A comprehensive tax administration reform proposal was prepared in early 2001<sup>8</sup> [Pakistan (2001)]. Implementation of these reforms, however, has been slow. While good progress has been made in a number of areas including establishment of a stronger tax administration, progress towards a generalised sales tax, and streamlining of income taxes, the reforms did not go to the full length of radical reforms proposed by the Commission, especially concerning establishing a truly autonomous tax department.

**Managing Public Spending.** Along with high fiscal deficits, Pakistan's spending priorities has also been of major concern. In addition to interest cost of growing debt that has progressively absorbed a higher share of a stagnant revenue base, the largest other spending item has been spending on defense. So, between interest cost and defense, on average they absorbed about 70 percent of total revenues leaving very little for other needs including for social sector and infrastructure. A particularly striking story on how unhelpful the budget has been for poverty reduction is to look at the ratio of military spending to spending on health and education. Historically, spending priorities have been heavily biased in favour of defense spending and against health and education spending (see Figure 9). For example, even in the late eighties, the ratio of military spending to health and education spending was 250 percent, possibly the highest in the world. The bias against health and education spending improved very slowly in the 1990s.

A gradual improving trend emerged in the early 1991 following the adoption of the Social Action Programme, largely under the pressure of the donor community. As a result, this ratio improved as defense spending was curtailed and health and education spending was increased. In terms of levels, the gradual improvement allowed Pakistan's social spending to recover from a low of below 2 percent of GDP in 1980 to 3.0 percent of GDP in 1999. Since then there has been some decline in

<sup>8</sup>The Task Force for Tax Administration Reform was led by Shahid Hussain.

Fig. 9. Pakistan: Trends in Selected Fiscal Indicators.



health and education spending as a share of GDP, but other spending on poverty programmes has increased including on water, sanitation, and basic infrastructure as a part of implementation of the I-PRSP. On health and education, the government is rightly focusing attention on improving service delivery to improve quality of public spending. Yet, while continuing to focus on quality improvements, the recent decline in spending on health and education needs to be reversed soon and expanded to meet the tremendous financing needs to address Pakistan's social gap.

In the face of this poor historical spending pattern, the fiscal adjustment needs of the 1990s created further difficulties. Since resource mobilisation effort did not achieve much success, the bulk of the fiscal adjustment burden fell on public spending, which declined from 26 percent of GDP in 1975 to only 22 percent in 1999 and then increased only marginally over the 2000-2002 period in response to improved fiscal space. As noted earlier, the effects of the fiscal crunch on economic growth was predictably negative. Clearly, while fiscal stimulus of the 1970s and 1980s fueled economic growth in these two decades, such fiscal stimulus was unsustainable [Ahmed (1994)]. The budget tightening in the 1990s that was necessary to avoid financial bankruptcy created difficulties for economic growth in the 1990. The creation of fiscal space in the decade of the 2000 will be essential to support essential public spending in infrastructure and Operation and Maintenance (O&M) to restore the growth momentum. Equally important, public spending on social sectors and other poverty programmes will be necessary to reduce poverty in this decade. So, the recent progress with creation of fiscal space is a welcome development [World Bank (2003)].

**Allocating Responsibility by Levels of Government.** While by Constitution Pakistan is a federation comprising of 4 provinces and two federally administered territories, fiscally the country has been heavily centralised. The 1973 Constitution has well identified areas of expenditure responsibilities, but commensurate distribution of revenue assignments has been a serious problem [Ahmed and Shah (1995)]. Bulk of the revenues are collected at the federal government level and then allocated to the Provinces by means of the periodic awards of the National Finance Commission. Thus, even in 2002, Federal revenues were 95 percent of total revenues, staying roughly unchanged since 1975. Regarding local governments, under the 1973 Constitution, these are the responsibility of the provincial governments. The experience with local governments has been quite dismal with little or no progress until the military government took over in 1999. The military government initiated a major initiative to devolve responsibilities to elected local bodies. So, a major change happened in 2001 when local body elections were held and elected district governments came into power with the mayor as the head of these governments. However, while these elected local governments brought in a major institutional change, enabling these governments with administrative capacities and financial autonomy remains major challenges.

What has been the outcome of this heavily centralised administration for development performance? While there are some clear advantages in terms of coordination of macroeconomic policy including debt management, the biggest disadvantage has been the delivery of public services. Even though the jury is out on the international evidence on the role of decentralised governments in service delivery [World Development Report (2004)], it is fair to conclude that Pakistan's heavily centralised system of service delivery has not worked. This is perhaps best illustrated through the experience with delivery of basic social services (education, health, water supply).

While low budget spending has been a major constraint to human development in Pakistan and partly explain the social gap in Pakistan, the effectiveness of this spending in achieving desired outcomes is even more worrisome. Prodded by donors for inadequate attention to human development, in 1991 Pakistan launched an ambitious Social Action Plan (SAP) aimed at correcting the social gap, especially to address the substantial anti-female bias. The effort did lead to some significant increase in public spending on social sectors, but the performance in terms of human development outcomes has been disappointing [Ahmed (2002); World Bank (2002a) and World Bank (2002b)]. What went wrong? While no doubt the additional resources made available was a welcome move, the reason it did not achieve tremendous success in term of human development outcomes was because of poor governance, partly due to the heavily centralised system of service delivery. Among the problems included: (i) political interference in the selection of schools and health care sites; (ii) political influence rather than merit in the selection of teachers and health workers; (iii) political



influence rather than merit in the location and transfer of staff; (iv) serious problems in procurement of goods and services related to these services; (v) abandoned and unfinished buildings; diversion of school and health facilities for other uses, including for private gains; (vi) ghost and absentee staff in school and other public facilities; (vii) severe imbalance between spending on staff and materials; and (viii) frequent problems with the timely release of funds from the centralised federal and provincial ministries.

The centralised delivery system meant there was very little interaction between the authorities in the Federal and Provincial capitals, who were responsible for major decisions including financing, procurement and programme implementation, and those who were at the receiving end of the service provision chain at the district and village levels. There was no system of accountability due to the disconnect between decision makers, providers and beneficiaries. The beneficiaries lacked both a participation in decision making as well as a voice to influence decisions indirectly. So, when teachers or doctors did not show up for work, when school buildings or health clinics were left half completed, and when salaries were drawn by representatives of ghost teachers or health care workers, there was little effective follow-up to correct these problems.

To remedy this problem, a major initiative was launched in 2001 to restructure the government by devolving authority to elected local governments [Pakistan (2001)]. The initiative involves creating full-fledged district and municipal governments having legislative and financial powers. The key objective is to bring government closer to the people and therefore getting communities better integrated with the government. Devolution is seen as an effective way of giving the right incentives to all relevant parties to ensure good provision of public services. Thus, the expectation is that local governments will be influenced by the beneficiaries to ensure that providers deliver good services. So, the hope is that devolution would improve decision making and government accountability for provision of public services by establishing better connectivity of service providers and beneficiaries.

Initial evidence regarding greater community oversight happening at local level and leading to better service outcomes is encouraging. For example, many school management committees have been established and they have had considerable success in reducing the cost of school construction. School committees are also having a positive impact on teacher attendance through surprise visits and follow-up. Although such committees could also function under a centralised administration, the fact that these have only emerged now under the local government umbrella is a positive development.

Despite this initial progress, there is still a long way to go on the devolution front. Local governments do not yet have full control over the staff and finances of devolved departments. Capacities of these governments are very limited and fiduciary oversight mechanisms are not in place. Importantly, very little fiscal

devolution has happened, in particular regarding revenue assignments or improved transfer arrangements. Getting the inter-government fiscal assignments sorted out efficiently remains a major challenge.

**Predictability and Transparency of the Budget.** The budgetary process in Pakistan suffers from a number of weaknesses that reduce the effectiveness of the budget. These include:

- lack of strategic focus and clarity on sectoral priorities;
- inadequate information on the cost of policies, programmes, and services;
- short-term horizon for budget decision making that fails to account for the long-term costs and benefits;
- an artificial separation of development and recurrent budgets, weakening the integrated, strategic content of the budget; and
- end of year spending incentives that reduce the efficiency of spending.

The presence of these drawbacks has typically meant inefficient spending decisions. For example, the separation of development and recurrent spending has meant inadequate attention to the recurrent cost implications of capital spending. Indeed, operation and maintenance (O&M) has typically tended to be short-circuited causing low returns from capital spending. Lack of good costing analysis of public programmes and policies has similarly meant inappropriate or inadequate funding of many programmes, leading to poor efficiency of these programmes. Many public programmes are based on political expediency rather than based on a careful analysis and choice of competing priorities, again contributing to low returns from such spending. One well-known example of this is the funding of MNA/MPA (members of national and provincial assemblies) sponsored schemes practiced by all governments since the early 1990s, whereby funds were allocated to members of national/provincial assemblies for development activities in their constituencies. Experience showed mostly abusive use of these funds with little development impact.

In response to these weaknesses, the government recently has taken a number of initiatives to improve planning and budgeting. The strategic content of the budget is being strengthened by linking the budget to the implementation of the government's Poverty Reduction Strategy (PRS). Efforts have been initiated to improve the costing of the various poverty programmes with a medium-term focus. In this regard, work is now underway to establish a comprehensive and detailed Medium-Term Budgetary Framework (MTBF) with the help of technical assistance from the United Kingdom. These are important positive steps, but there is a long way to go. Among the issues that need more effort and resolution include: assigning clear responsibilities between different levels of governments and line ministries in the formulation of the MTBF; capacity to do detailed costing of programmes and policies; establishing sectoral and programme priorities; setting realistic programme

goals and targets; and strengthening the relationship between the PRS and the annual budgets.

**Expenditure Tracking and Monitoring.** One key factor underlying the low effectiveness of public expenditure in Pakistan has been a dysfunctional expenditure monitoring system. The traditional monitoring emphasis has been on spending of budgetary allocations rather than on outcomes. Thus, the success of budget implementation is judged on the basis of how closely actual spending matched the allocated budget. The tracking of expenditure has also been constrained by inadequate attention to data quality and timeliness.

Very recently, as a part of the PRS, an effort is now underway to establish a fairly detailed mechanism to monitor poverty-related expenditure, along with their intermediate indicators and outcomes, in relation to the specific human development and poverty targets in the PRS. This mechanism, when fully functional, can provide a powerful analytical tool to assess the effectiveness of public spending in achieving stated outcomes. The success, however, requires a long-term effort to increase monitoring and evaluation capacity and strengthen the underlying data base in terms of quality, comprehensiveness and timeliness at the district level and moving upwards.

**Public Accounts.** Although on paper Pakistan has a reasonably sound financial accountability set up, in practice weak financial accountability has been a fundamental institutional constraint on public spending [World Bank (2002c); World Bank (2003b)]. Major concerns include:

- ineffective parliamentary and executive control of the budgetary spending—audit reports on annual accounts are heavily qualified and accounts of different levels of government do not currently meet the expectations of the Constitution and associated laws and regulations; for example, the audit reports focus only on irregularities in individual transactions without sufficient attention to significance and systematic weaknesses of financial management system. Similarly, the legislative oversight of the accountability system is weak. The Public Accounts Committee meets only infrequently and lacks the expertise to undertake proper review. Importantly, follow-up to audit findings and PAC recommendations is very poor;
- the accountability of the executive is not sufficiently supported by information that would enable it to become focused on results and outcomes;
- the separation of audit and accounts took a long time to come; even now the process is yet to be completed. For example, the Auditor General continues to exercise control over both audit and accounts staff;
- financial management capacity at the provincial level is uneven and almost non-existent at the district level;
- although a system of penalties exist, these sanctions and associated

implementation is inordinately cumbersome and lengthy;

- the quality of audit suffers both from quality and timeliness of data as well as low staffing quality.

The government has recently embarked on a comprehensive reform programme to restructure its financial management system. Significant financial autonomy and responsibility has been devolved to the line ministries through the introduction of a New System of Financial Control and Budgeting. This has been accompanied by imposition of a hard budget constraint through strict expenditure ceilings. The spending agencies are accountable for ensure financial discipline including timely reconciliation of financial data. The government has accepted a review of fiscal reporting and transparency under the IMF's *Code of Good Practices on Fiscal Transparency*. Consolidated fiscal accounts are posted on the Finance Ministry's website on a quarterly basis. The federal and provincial PACs have been made more effective and the backlog of audit reports has been significantly reduced. In one Province (NWFP), the findings of the PAC have been made available to the public via timely press releases.

These are positive steps forward. Further actions are needed to strengthen financial management, especially at the provincial and district levels. Capacities are very weak at these lower tiers of government and a long-term effort is needed. The system of internal controls requires strengthening; proper accounting and management of contingent liabilities at all levels of government remain to be addressed; quarterly and annual financial reports of all levels of governments need to be published; the capacities of PACs require strengthening; and follow-up to audit reports need more attention.

#### IV. CONCLUDING REMARKS

Management of the government budget has been a major challenge in Pakistan. Fiscal expansion fueled rapid growth during 1970s and 1980s, but led to serious macroeconomic imbalances in the 1990s, disrupting growth. Quality of spending has been a major problem as well, with low priority to human development and essential infrastructure. These factors have contributed to a stagnation in the progress with poverty reduction during the 1990s. Low spending on human development along with poor service delivery have resulted in very slow improvement in human development indicators in Pakistan overall, making it a negative outlier in terms of poor human indicators relative to countries with similar per capita income levels. Weak management of the budget in turn reflect a number of major institutional constraints relating to debt management, tax administration, expenditure planning, assignment of responsibilities by levels of government, monitoring and evaluation and financial controls and accountability.

Half-hearted attempts to improve fiscal management in the 1990s met with limited success. While the fiscal deficit was significantly reduced, defense spending was cut and spending on health and education was increased, the reform efforts fell short of securing a strategic improvement in Budget as an instrument for growth and poverty reduction. However, since the advent of the military government in 1999, there has been a more systematic and comprehensive effort to address many of the institutional constraints to improved budgetary management. The strategic objective of the reforms, underpinned by a PRS, is to restore the growth momentum, reduce poverty and improve human development. Debt management has received considerable attention, including further reduction in fiscal deficit and reduction in cost of borrowing. A debt management unit has been set up to monitor debt and ensure consistency with fiscal policy. Importantly, legislation is planned to enact a Fiscal Responsibility and Debt Reduction law. These are laudable efforts. While a Fiscal Responsibility Law by itself does not necessarily guarantee fiscal discipline, having such a legal cover can be a powerful instrument in the hands of a reform minded finance minister. The debt management unit, similarly, can be a very helpful resource for ensuring financial prudence, provided the unit is adequately equipped to do the needful monitoring and analysis which then is fed in the budget process. The experience so far suggests that there is still a way to go in this area.

Despite some important positive developments, overall progress on tax administration has been slow due to many anti-reform powerful lobbies and opposition of vested interest. One example of this is the weak progress with the implementation of agricultural income taxation. While the appointment of a strong tax administration team is very important, this alone is not enough. Without strong political support and adequate autonomy to the tax department, progress will be constrained. Also attention needs to be given to strengthening tax administration at the provincial and local levels.

Setting of expenditure priorities to reflect the government's commitment to growth and poverty reduction has been partly constrained by prior claims on the budget from debt servicing and defense. With the reduction in the debt burden as well as the cost of borrowing, the interest cost of the budget has shown a downward trend after more than 30 years. Also, efforts to contain defense spending started in the 1990s has been maintained. These developments have helped create some fiscal space to finance poverty and growth related programmes. The effective use of this fiscal space for growth and poverty programmes will remain a major challenge moving forward. Strong efforts will be needed to resist any attempts to blow up this fiscal space in extravagant or non-development schemes as in the past.

The assignment of expenditure accountability by levels of government has progressed well, especially with the establishment of the local government. The formal establishment of the local government is indeed a major step forward. However, as is well-known, decentralising expenditure responsibilities by itself will

not necessarily lead to better service delivery. Other reforms needed include financial solvency and autonomy of local governments, ensuring that these governments have adequate capacity, establishing a system of accountability between beneficiaries, service providers and local governments, establishing performance monitoring and evaluation system, and oversight of the higher levels of government. Progress in these areas is less clear and the experience is still evolving. This remains a major challenge for Pakistan.

Regarding public expenditure management, efforts underway to prepare a Medium-Term Budgetary Framework is a welcome development along with the DFID technical assistance. The strategic content to the MTBF is provided by the PRS, which is also moving along. The implementation of the MTBF, however, has been rather slow. International experience suggests that this can be a powerful tool to improve the effectiveness of public spending provided it is well implemented. This requires a serious effort, including enhancing the capacity of the Ministry of Finance and other line ministries to undertake this exercise, especially regarding ability to link the MTBF to the PRS, and update this as necessary. The underlying data needs (e.g. costing of sectoral programmes) are quite substantial.

The effort to improve monitoring and evaluation as a part of the PRS is a positive development, although progress is rather slow. M&E needs are substantial and required at all levels of government. Indeed, M&E at the district level will be the key to ensuring availability of reliable and adequate indicators of progress with stated outcomes. This is a major challenge as capacities at the local level are weak.

Finally, despite recent progress with financial management, there remains a long-term agenda for strengthening financial management and accountability, especially at the local levels. Establishing adequate oversight of parliamentary committees and follow-up to the recommended actions are particularly important.

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## Comments

The paper by Sadiq Ahmed focuses on budget as a core institution and on its impact on poverty reduction through provision of services and targeted programmes. The paper examines the need for reforms in the institutional dimensions of budget to make it more effective for poverty reduction. The paper concludes that the management of budget, lack of quality in spending, and half-hearted attempts to deal with the problem of fiscal deficits indicate a need for greater and improved efforts. The study is interesting and useful. However, for more comprehensive coverage, the study should also include the discussion on the following issues.

- (1) The study seems to suggest that budget deficit is bad. Is it always the case? If not, then what are the reasons that it is becoming a critical issue for Pakistan.
- (2) The debt situation is highlighted as the major problem facing Pakistan's economy. However, instead of comparing the amount of debt, it will be more meaningful to compare the NPV of debt.
- (3) Introduction of fiscal responsibility bill should be considered only if its implications are fully worked out.
- (4) For tax reforms, improving tax collection is a critical issue. It can result in a substantial increase in revenue if the large tax-payers are evading taxes. Therefore, the issue of improving governance may be more critical than the issue of enlargement of the base. Furthermore, effective implementation of agricultural income tax may result in substantial revenue gains.
- (5) The introduction of medium term budgeting (for revenue and expenditure), new accounting framework based on accrual are important policy reforms. The implications of these reforms should be highlighted.
- (6) General data availability and reconciliation of data from various sources are critical issues. The fiscal reforms package must include this aspect. It will help to reduce the discretionary elements in the budgets.
- (7) The reforms are undertaken in other areas of the economy. The inter-linkages between these reform programmes should not be ignored particularly if the issues of sequencing of reforms needs to be examined.
- (8) The emphasis of the paper is on revenue collection and reforms. The expenditure side of the budget is not given sufficient attention. In order to examine the impact on poverty the expenditure side of the budget may be more important.



Keeping in view the importance of the topic and the need for research in this important area, this paper is a useful starting-point.

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